FEB 27 19
JOHN T. FEY, C

IN THE

Supreme Court of the United States

OCTOBER TERM 1956

No. 804

JOSEPH KANE,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

BERNARD WEISS
Counsel for Petitioner
136 East 57th Street
New York 22, N. Y.

INDEX

PAGE

Citations to Opinion Below 1

Jurisdiction 1

Questions Presented 2

Statement 3

Reasons for the Granting of the Writ 4

Conclusion 15

Appendix 17

CITATIONS

CASES:

Bogardus v. *Commissioner of Internal Revenue*, 302 U. S. 34 10

Earl, Lucas v. 281 U. S. 111 8

Horst, Helvering v. 311 U. S. 112 ..... 8, 12

Leininger, Burnet v. 285 U. S. 136 8

LoBue, Commissioner of Internal Revenue v. 351 U. S. 243 9

McNamara v. *Commissioner of Internal Revenue*, 210 F. (2d) 505 ..... 9, 11

Palmer v. *Commissioner of Internal Revenue*, 302 U. S. 63 ..... 3, 13, 14

Reece v. *Commissioner of Internal Revenue*, 233 F. (2d) 30 12

Smith, Commissioner of Internal Revenue v. 324 U. S. 177 ..... 8, 12

Van Dusen v. *Commissioner of Internal Revenue*, 166 F. (2d) 647 ..... 9, 10

NOV 3 1958

246008

PAGE

STATUTES:

Internal Revenue Code of 1939 Section 22(a) . . . 4, 8, 10

REGULATIONS:

Section 29.22(a)-1 . . . . . 3, 14

MISCELLANEOUS RULINGS:

I. T. 3795 . . . . . 3, 14, 15

IN THE

Supreme Court of the United States

OCTOBER TERM 1956

JOSEPH KANE, *Petitioner,* v. COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	No.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit, entered December 5, 1956, sustaining the decisions of the Tax Court of the United States in the above-entitled proceedings.

Citations to Opinions Below

The findings of fact and opinion of the Tax Court of the United States (R. 5-25) is reported in 25 T. C. 1112. The United States Court of Appeals for the Second Circuit affirmed per curiam on December 5, 1956, not yet officially reported.

Jurisdiction

The United States Court of Appeals for the Second Circuit, having affirmed the decisions of the Tax Court of the United States on December 5, 1956, the jurisdiction of this Court is invoked under 28 U. S. C. Section 1254(a).

Questions Presented

I.

Did the petitioner realize any taxable income upon the exercise in 1945, 1946 and 1947 by petitioner's wife of a stock option granted to her by Arde Bulova to purchase stock of the Bulova Watch Co. Inc. (petitioner's prospective employer) owned by him personally where (a) at the time the option was granted the market price was not in excess of the option price; (b) petitioner's wife used her own funds in acquiring such option-stock, kept the stock and the dividends therefrom and reaped the benefits of such ownership; (c) it has been stipulated that no stock option had been granted to petitioner prior to March 31, 1947; and (d) neither Arde Bulova nor the Bulova Watch Co. Inc. claimed or was allowed any deduction from income by reason of the granting or exercise of the stock option?

II.

In the alternative, assuming, arguendo, that the stock option was granted in 1944 to or for the benefit of petitioner, does not the agreement between Arde Bulova and petitioner's wife effectively work an assignment of such option and therefore limit petitioner's taxable gain to the appreciation in value of the stock option to the assignment date?

III.

In the second alternative, accepting, arguendo, that the stock option agreement was for the benefit of the petitioner, is not the increase in value of the option-stock, measured by the difference between the option price and the market value of the stock on the date of exercise, exempt from tax

in the light of the rationale of the U. S. Supreme Court decision in *Palmer* v. *Commissioner of Internal Revenue*, 302 U. S. 63?

IV.

In the third alternative, may the Commissioner of Internal Revenue arbitrarily apply or withhold the application of Regulations 111 Section 29.22(a)-1 as interpreted by I. T. 3795 issued in April 1946, so as to discriminate among taxpayers?

Statement

Petitioner duly filed petitions for the redetermination of the deficiencies set forth by the Commissioner of Internal Revenue in his "90-day" deficiency notices with the Tax Court of the United States, Docket Nos. 50587 and 52755. On July 14, 1954, a motion to consolidate these cases was granted. The Tax Court filed its findings of fact and opinion and entered its decisions on February 29, 1956.

A motion by petitioner for full review by the Tax Court of the United States was denied by the Tax Court on March 8, 1956. On May 17, 1956, petition for review was filed with the U. S. Court of Appeals for the Second Circuit which affirmed the decision of the Tax Court of the United States on December 5, 1956.

The Tax Court of the United States determined that petitioner, Joseph Kane, realized ordinary taxable income in the calendar years 1945, 1946 and 1947 of $11,100, $19,650 and $12,200, respectively, by reason of the exercise by petitioner's wife, Rose, of an option to purchase stock of the Bulova Watch Co. Inc., which option was granted to her by Arde Bulova on 1,000 shares of his personally owned stock in that corporation at $37 per share.

The Tax Court held that the option to purchase the stock was intended as additional compensation for the husband's services and that the excess of the market value of the stock over the option price in each year in which stock was purchased by Rose Kane under the option was taxable income to her husband Joseph, under Section 22(a) of the Internal Revenue Code of 1939.

Reasons for the Granting of the Writ

(1) The decisions of the Court below in the instant proceeding involve the proper legal construction of Federal income tax statutes as set forth in the U. S. Internal Revenue Code of 1939 and regulations and rulings promulgated thereunder intended to implement such statutes.

The fundamental question involved in this application for a Writ of Certiorari is whether the petitioner is taxable under Section 22(a) of the U. S. Internal Revenue Code of 1939 on income alleged to arise by reason of the exercise by petitioner's wife, Rose, of an option to acquire stock in the Bulova Watch Co., Inc., granted to her by Arde Bulova, a 19% stockholder of the Bulova Watch Co., Inc., from his personally owned stock in said corporation.

The agreed and uncontroverted facts of this proceeding are that petitioner's wife used her own personal funds to acquire the stock from Arde Bulova and that she kept the stock and income therefrom at all times, and that neither the stock nor the income therefrom was ever turned over to or used by the petitioner in any manner whatsoever (R. 8, 9, 14); that at the time the option was granted in 1944, the market price of such option shares was not in excess of the option price. (A. 19).

The Tax Court has misconstrued this stipulated fact and labored under the impression that the said stipulation related to August 17, 1944. However, on that date the

market value was approximately $40 per share, as was noted by respondent on page 5 of his brief to the U. S. Court of Appeals, Second Circuit. Paragraph 5 of the stipulation (A. 19) referred to the date the option was granted, which was a few months prior to August 1944. (R. 8, 9)

On the dates the stock was purchased, namely, December 27, 1945, August 6, 1946 and July 2, 1947, the market price exceeded the option price in the amounts of $11,100, $19,650 and $12,200, respectively (R. 15); that at no time was petitioner's wife an employee of either Arde Bulova or the Bulova Watch Co., Inc., (R. 6); that petitioner was not an employee of Arde Bulova personally and that no stock option of any kind has been issued by Bulova Watch Co., Inc. or Arde Bulova to an employee of either prior to March 31, 1947. (R. 12)

This last finding of fact, which was stipulated to, standing alone, should preclude a finding that the option granted to Rose Kane by Arde Bulova was in reality an option granted to Joseph, an employee of the Bulova Watch Co., Inc.

The Tax Court further found that the employment agreement between Bulova Watch Co. Inc. and petitioner, exclusive of any alleged stock option, yielded greater compensation to the petitioner than he formerly had received from the Gruen Watch Co., petitioner's former employer (R. 21).

No person testified in the instant proceeding that the stock option given to Rose Kane was intended as compensation to petitioner or was intended to induce petitioner to accept employment. To the contrary, all persons who were in the best position to know the facts, including petitioner, his wife, Rose, and Arde Bulova, the grantor of the stock option, testified the option was not intended as compensation to petitioner (R. 19, 36) but was granted to Rose Kane

to assuage her personal unhappiness in giving up her home, her friends and her social position in Cincinnati, Ohio, and in a measure to provide a means for possible future reimbursement for losses suffered by Rose in giving up her home in Cincinnati and the expense incident to moving to New York City (R. 34, 41).

Furthermore, neither the Bulova Watch Co. Inc. nor Arde Bulova claimed or were allowed any deduction for the amounts alleged to constitute compensation to petitioner in the year the option was granted or exercised (R. 14).

The basis for the Tax Court's opinion was that it considered the granting of the option a "clincher" for the petitioner to accept employment (R. 24). The Tax Court spelled out the option as part of the employment arrangement, not from any testimony or from any written documents which stated that the option was part of the terms of employment, but from a clause in the option agreement which stated that the shares could be purchased—300 during the first year, 300 during the second year and 400 during the third year of petitioner's employment by the Bulova Watch Co. Inc. Arde Bulova testified that he used such terminology only because he did not think Mrs. Kane could finance the whole purchase at one time, though he would have allowed her to do so at any time (R. 37). The Tax Court has read into the employment agreement terms not expressed therein. The employment agreement is not ambiguous; there has been no dispute between the parties to the agreement as to the meaning of its terms; and there is no basis for the Court to alter what is expressly stated therein.

Any alleged ambiguity between the testimony of the witnesses and statements contained in the option agreement was adequately explained by Arde Bulova and Rose Kane.

The Tax Court found that Arde Bulova knew at the time the option agreement was granted to Rose Kane that

a stock split-up would occur a year later and that such knowledge was indicative that the option agreement was an additional inducement to the petitioner to accept employment with Bulova Watch Co. Inc. (R. 22). No testimony was requested or given to this effect. On the contrary, though Arde Bulova subsequently recognized the stock split by allowing Rose Kane to buy double the number of shares at half the price stated in the option agreement, the option agreement itself failed to even mention what adjustment of the option price or of the number of shares would be necessary in the event of a stock split-up. This is the best proof that a split-up had not been contemplated on the date the option was granted and the Tax Court erred when it considered such stock split-up a material factor in arriving at its ultimate conclusion that the option was intended as compensation to petitioner.

The fact that the written agreement between the Bulova Watch Co. Inc. and petitioner and the option agreement between Arde Bulova and petitioner's wife, were dated the same date was considered by the Tax Court as an additional circumstance establishing that the option agreement and the employment agreement were but one transaction. However, the evidence in the case clearly establishes that the agreements of petitioner with Bulova Watch Co. Inc. and petitioner's wife with Arde Bulova were separately and independently arrived at a long time before the agreements were reduced to writing; that petitioner's wife had already given up her home in May 1944 (R. 9) and moved to New York and that the simultaneous dating was only a matter of convenience when all parties were available in New York City during a summer vacation period (R. 9, 35).

Fundamentally, the Tax Court went far afield to arrive at its ultimate conclusion of fact that the stock option to petitioner's wife, Rose, was part of the employment agreement between Bulova Watch Co. Inc. and petitioner, and

thus constituted taxable income under Section 22(a) of the U. S. Internal Revenue Code of 1939.

In applying the law to the facts in this proceeding the Tax Court compared this case with the cases of *Lucas* v. *Earl,* 281 U. S. 111, *Burnet* v. *Leininger,* 285 U. S. 136, and *Helvering* v. *Horst,* 311 U. S. 112 (R. 25). Those cases stand for the proposition that a taxpayer cannot avoid tax by anticipatory assignment of income.

In applying those cases the Court, as well as respondent, treated Rose Kane, on the one hand, as the owner of the stock bought under the option and taxable on the dividends therefrom (R. 14) while at the same time treated petitioner as the owner of the option—a position that is highly contradictory, particularly since Rose owned the option for 16 months before the option was exercised.

The Tax Court, by treating the option as petitioner's, is transferring an asset from one spouse to the other, though it recognizes that the income of each is separately taxable. The Internal Revenue Code of 1939 allows separate returns to be filed by each spouse and they were so filed (R. 6).

The Tax Court's decision would in effect destroy the right of married persons to have their own separate assets and income. A dramatic illustration of the consequences of the Tax Court's decision would be a divorce during the option period. In such event, would the Court hold that petitioner had to pay a tax on the increase in the value of the option when exercised even though he had no right to the stock and all the economic gains accrued to the divorced wife?

The Tax Court evidently misunderstood and misapplied the principles of *Commissioner of Internal Revenue* v. *Smith,* 324 U. S. 177. The Smith case pertained to an option granted to an *employee* to acquire the *assets of the employer* to be received by the employer as a result of the

efforts of the employee. When the assets were so received by the employer corporation and thereafter transferred to Smith for a nominal consideration, the value of such assets was greatly in excess of the option price. Obviously the transfer of corporate assets to an employee at substantially less than fair market value admittedly given in consideration of services rendered constitutes taxable income, and the Supreme Court so held.

Those are not the facts in this proceeding.

In the case of the *Commissioner of Internal Revenue* v. *LoBue,* 351 U. S. 243, the employee, LoBue, received a *non-transferable* stock option to buy stock of the employer-corporation from the *employer* at a price considerably below the market price of such stock on the date the option was granted. The Supreme Court agreed with the Commissioner of Internal Revenue that the stock of the employer was transferred to LoBue to secure better services and thus was plainly compensation. However, the Supreme Court did say that options may have an ascertainable market value when received, and if the option were transferable, the receipt of a stock option could result in immediate taxable income. A foot note in the LoBue case indicated that such a condition existed in *McNamara* v. *Commissioner of Internal Revenue,* 210 F. (2d) 505 (C.A.-7, 1954).

A similar observation that a stock option might under certain circumstances constitute taxable gain on its receipt is also made in the *Smith* case previously referred to.

The decision in *Wanda Van Dusen* v. *Commissioner of Internal Revenue,* 166 F. (2d) 647, relied on by the Tax Court below, can easily be distinguished on its facts. In that case the option was given to the *employee,* Van Dusen, by the president of the corporation, Fleet, who owned 45% of the stock of the employer, to acquire stock of the corporation from the president at a price of $5. per share;

the number of shares were limited to 50 per month, as long as the employee and Fleet were employees of the corporation. At the date the option was granted, the market price was $9. per share. The Circuit Court held there was no question that the option was intended as compensation and *Fleet, the optionor, so testified.*

In this proceeding, Arde Bulova, the grantor of the option, testified that the option *was not intended* as compensation and was in fact granted to Rose Kane and *not to petitioner*. In the *Van Dusen* case, Fleet, the grantor of the option, testified that the option was granted as compensation to obtain and retain the services of Van Dusen for the corporation.

In the *Van Dusen* case, the grantor's own income was measured by the successful efforts of the employee, and furthermore, he owned 45% of the corporation, whereas Bulova's compensation did not in any manner depend on the efforts of this petitioner, and his 19% ownership would not justify him in granting the option because he might indirectly benefit.

The conclusion is inescapable that the option not having been given to the petitioner but to another taxpayer, Rose, and not by an employer, any income arising from the exercise of said option would be taxable to her and not to petitioner, especially where she acquired the stock with her own funds, received and retained the dividends, was entitled to all the benefits of ownership and was the owner of the option for 16 months prior to its exercise by her.

In *Bogardus* v. *Commissioner of Internal Revenue*, 302 U. S. 34, the Supreme Court held that payments voluntarily made by a corporation to individuals who were neither employees of the corporation or its stockholders, nor stockholders of the paying corporation, did not result in taxable income to recipients under the broad provisions of Section 22(a) of the tax statutes, even though the re-

cipients had been employees of a predecessor corporation. The applicability of this case to instant petitioner is obvious. He was not a stockholder in Bulova Watch Co., Inc. and the option rights, even if considered his, were not received from any employer.

If petitioner did derive taxable income from the option given to his wife to buy from Arde Bulova stock in the Bulova Watch Co., Inc., said income would be taxable in 1944 upon the receipt of the option and limited to the fair market value of the option when received in accordance with the decision in *McNamara* v. *Commissioner of Internal Revenue,* 210 F. (2d) 505.

In that case the U. S. Court of Appeals, Seventh Circuit, held that the taxable income of taxpayer was limited to the market value of the option at the time of its receipt where said option was a transferable one.

If the option in question in this proceeding is deemed to have been petitioner's, there is no question it was a transferable one, otherwise it could not have been given to Rose. Moreover, the agreement itself contained no restriction on further assignments by Rose, should she have so desired.

On the date the option was reduced to writing, the market price of the stock was approximately $3 per share higher than the option price as the respondent pointed out in his brief, page 5, to the U. S. Court of Appeals, Second Circuit. Therefore, the second requirement of immediate market value (a long term "call" on stock $3 per share under current market) is present.

Clearly the decisions of the Second and Seventh Circuits, U. S. Courts of Appeal, are in conflict and the Supreme Court should grant the writ of certiorari requested and settle the difference in applicable legal principles.

The situation present in the instant proceeding and the *McNamara* case was envisioned by the Supreme Court

in *Smith* v. *Commissioner of Internal Revenue,* 324 U. S. 177, when the Court stated, on page 181 of that opinion:

> "When option price is less than the market price of the property for the purchase of which the option was given, it may have present value and may be found to be compensation for services rendered."

2. In the alternative, if the option granted in 1944 by Arde Bulova to petitioner's wife, Rose, were considered to have been originally granted to or for the benefit of petitioner, then such option agreement to Rose, in effect, worked an assignment and thus limited petitioner's taxable income, if any, to the value of the option on the date of assignment.

There is no question that the option itself was a property right and the [redacted] one who had the right to exercise the option, and therefore owned the property right, was Rose. Any gains that accrue thereafter perforce belong to the owner of the rights.

In *Helvering* v. *Horst,* 311 U. S. 112, the Supreme Court in holding that an assignor was taxable on the income of the transferred interest coupons detached from the bonds, distinguished such ruling from the instance of "rent from a lease or a crop raised on a farm after the leasehold or farm had been given away. *Blair* v. *Commissioner,* 300 U. S. 12, 13."

In the instant proceeding, even if the option were considered to have been petitioner's originally, which is contrary to a specific stipulation of fact, the option was "given away" to petitioner's wife a full 16 months before exercise, and any gain accruing during that period should not be taxable to petitioner.

In *Reece* v. *Commissioner of Internal Revenue,* 233 F. (2d) 30, the U. S. Court of Appeals for the First Circuit held that no taxable income was derived by assignor after property (in this case right to royalties) was assigned to taxpayer's wife.

As a practical matter, the U. S. Courts of Appeals for the First and Second Circuits are applying different legal principles in determining who is taxable on income arising subsequent to the date of assignment.

Under the facts in this proceeding, there was no anticipatory assignment of income. On the date the option was orally granted to Rose by Arde Bulova, the market price of the stock did not exceed the option price (A-19). If the date the option was reduced to writing is treated as the controlling date, the market price of the stock was approximately $3 per share higher than the option price and any taxable income must be limited to 1944 and in that amount.

3. Assuming, arguendo, that the option agreement between Arde Bulova and petitioner's wife was for the benefit of petitioner, then petitioner is exempt from taxation on any increase in value of the option rights, in accordance with the rationale of *Palmer* v. *Commissioner of Internal Revenue,* 302 U. S. 63.

In the Palmer case, the Commissioner of Internal Revenue sought to tax the petitioner (under the broad application of Section 22 of the U. S. Internal Revenue Statutes) on the appreciation in value of subscription stock rights, measured by the difference between the market value of the stock being purchased on the date of the exercise of rights and the subscription price, as a dividend on the theory that property was being transferred to a stockholder by the corporation at a price substantially below the market price. This Court held that where the corporation transfers to its stockholders rights to acquire assets at a reasonable price and the value rises between the date of issuance of such rights and the date of actual delivery of the assets, taxable income does not result. The Court stated,

> "When the corporation has committed itself to a sale of its assets to stockholders at present market value, the effect on its balance sheet is the same as in the case of other vendors who in various ways assume the risk of rising prices pending the consummation of the sale. In every sale purchasers may, as a result of market change, acquire property at less than its value on the date of acquisition. But in the case of the corporation, it does not follow that there has been a distribution of its profits. It can hardly be said that profits accrue to a corporation from a fortuitous gain in market value, the benefits of which it has relinquished before the gain occurs."

Section 29.22(a)-1, of Treasury Regulations 111 promulgated under the Internal Revenue Code of 1939 and applicable to this proceeding groups in the very same sentence transfers of property "by a corporation to a shareholder, or by an employer to an employee, for an amount substantially less than its fair market value." This very juxtaposition of words indicates Congressional intent that both transfers from corporations to stockholders and employers to employees should be treated alike. The rationale contained in *Palmer* v. *Commissioner of Internal Revenue, supra,* is therefore applicable to this proceeding.

4. In the final alternative, even assuming, arguendo, that the option granted to Rose Kane by Arde Bulova was in fact to petitioner, petitioner contends that Regulations 111, Section 29.22(a)-1 (as interpreted by I. T. 3795 issued in April 1946) in effect for the taxable years involved in this proceeding with respect to stock options granted prior to February 28, 1945 expressly excludes from income the appreciation in value of certain employee stock options from the option date to the exercise date. The respondent may not, after publishing and applying said principle of law for many years and which has received implied Congressional

approval by enactment of tax statutes with no change being made, refuse to apply said provisions to the instant case of petitioner.

The option at issue conforms to the definitive requirements since under the stipulated facts of this case the option was given in 1944 at a time when the market price was not in excess of the option price and no deduction attributable to any aspect of the option was claimed at any time.

At the minimum the issuance of I. T. 3795 confirming prior interpretations of regulations under Section 22 of the tax statutes must govern the exercise of stock options in 1946 and 1947 which exercise occurred after the issuance of I. T. 3795.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

BERNARD WEISS
Counsel for Petitioner
136 East 57th Street
New York 22, N. Y.